Significant OECD Developments in International Tax: Article 7 Update

International Association of Tax Judges

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Articles 7-1 OECD MC (2010) and (2008) compared

Article 7-1 (2010)

- "Profits of an enterprise of a Contracting State shall be taxable only in that State
- unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein.
- If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State."

Article 7-1 (2008)

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OECD's Article 7 project

- Completed in 2010
- "Attribution of profits to Permanent Establishments" (Report (2010))
- Report 2010 fully incorporated in the Commentary (2010) to Article 7 (2010)
- Report 2008 partly incorporated in Commentary (2008) to Article 7 (2008)

- The set of OECD views on Article 7 is called the "Authorized OECD Approach"

Theoretical background

From 2010 onwards: two Articles 7 and Commentaries

- Article 7 (2008) and Commentary (2008)
  - Commentary 2008 is only partly based on Report 2008
  - Applies to most of the existing treaties
  - (Seven paragraphs)

- Article 7 (2010) and Commentary (2010)
  - Commentary (2010) is fully based on the Report (2010)
  - Elimination of Article 7-3 (2008), 7-4 (2008), 7-5 (2008) and 7-6 (2008)
  - Introduction of Article 7-3 (2010) on corresponding adjustments
  - Applied in which concrete treaties?
  - (Four paragraphs)

Interpretation: the role of the Commentary

- Article 5 Convention on the Organisation for Economic Co-operation and Development:
  - “The Organisation may (a) take decisions which ... shall be binding ... (b) make recommendations to Members...”
- Recommendations are not legally binding, but are politically
- Recommendation relating to OECD Model Convention binds only the Executive not the State as a whole (Judiciary not included):
  - “Recommends to the Governments of the Member countries: … that *their tax administrations follow the Commentaries* ... as modified from time to time...”
- Judiciary not bound to the Recommendation

The issue of ambulatory (dynamic) interpretation

- Executive:
  - To interpret treaties according to the last Commentary, irrespective of when the treaty was concluded

- Judiciary in many countries:
  - Takes the Commentary that exists at time of treaty conclusion as interpretational help
  - When interpreting older treaties, caution towards new Commentaries
  - New Commentary accepted if **clarification** of what was expressed in the earlier Commentary

Capital attribution in 2008 Commentaries is not a clarification

- 1963 and 1977 Commentaries:
  - Allocation of interest to the extent used for financing the PE
  - No mention of capital attribution

- 1994 Commentaries:
  - Suggestion to start looking for a capital attribution solution
  - But even for banks no agreement in the OECD

- 2008 Commentaries:
  - Primate for capital allocation

Authorized OECD approach

The essence of the “Authorized OECD Approach”

- Functionally separate entity approach
  - Treat the PE as a separate entity and give it the profits appropriate to its functions, asets and risks
  - Consequence: PE may have positive profits exceeding those of the Enterprise

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The methodology: two step approach

- Step 1
  - "Hypothesise the PE as a distinct and separate enterprise": functional and factual analysis
  - Consider whether dealings have taken place and whether these dealings may be recognised
- Step 2
  - Determine arm's length prices

Step 1 in more detail

- Functional and factual analysis
  - Identify the **Significant People Functions**

- Axioms:
  - Risks follow functions
  - Functions determine (economic) ownership and attribution of assets
  - Capital follows assets and risk

- Consequently, in step 2 the PE is rewarded for
  - the assets it “owns”
  - The risks it “incurs”

Capital attribution to the PE

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- Possible interpretational consequence: no capital attribution in pre-2008 treaties

(Free) capital

•A PE should have a suitable capital

•Defined as: an investment that does not lead to a return in the nature of interest that is deductible for tax purposes under the laws of the PE country

How to attribute capital?

- OECD leaves the choice to the Member country and its traditions:

  - **Capital allocation method**: pro rata allocation (assets and risks)

  - PE conducts a very different type of business compared to enterprise as a whole
  - Enterprise is thinly capitalized
  - War chest / temporary cash surplus

  - **Thin capitalization method**: allocation of an arm's length capital found with comparable enterprises

  - Some companies are highly geared and others are not; shareholder's appetite
  - PE capital might become larger than equity of the enterprise

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How to allocate interest?

- OECD leaves the choice to the Member country and its traditions:
  - **Fungibility method**: mathematical allocation of interest
  - **Tracing method**: allocation of the specific interest on the specific debt entered into for PE purposes

Internal interest (from HO to PE and vice versa)

- 2010 Commentary: possible
  - Recognition of internal "interest" if HO undertakes the significant people functions relevant to the economic ownership of the cash
  - Interest rate: arm's length
    - Comparable external interest rate reward for treasury activity (service fee or additional interest margin)

- 2008 Commentary: not possible

Example various combinations

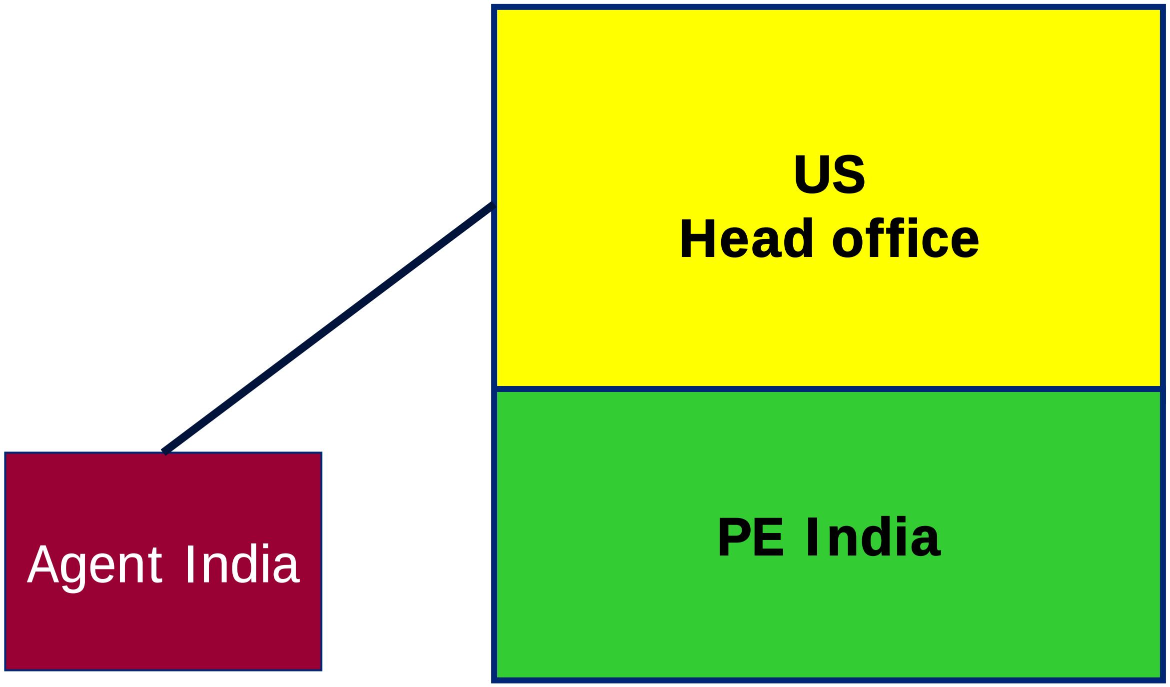
Balance sheet ***assets***	**Balance sheet** ***liabilities***	**Capital allocation** **+** **Fungibility**	**Capital allocation** **+** **tracing**	**Capital all.** **+** **Fungibility or thin cap** **+** **Internal interest**
Enterprise				
Assets 100	Capital 20 Debt 1 (10%) 10 Debt 2 (1%) 40 Provision 30			
Permanent Establishment				
Assets 50	Capital	Capital 10 Debt (Unspec) 40	Capital 10 Debt 1 10 Closing entry 30	Capital 10 Debt 1 10 Internal Debt 30

Dual or single tax payer approach

Dual or single tax payer approach?

- Commentary 2008: **dual tax payer approach (**i.e. if required, a separate profit for the dependent agency PE)
- Relaxation in Par. 269 Report 2008: in practice no profit for mere sales PEs

Dual taxpayer approach



- Assume 8 is adequate profit from Agent's function to <u>manage</u> US's risks (Agent does not <u>carry</u> US's risks)
- Assume 7 is adequate profit for US's risks drawn to PE (as in India the risk managing function is performed)
- Commentary 2008: 8 taxed with Agent, 7 with PE
- TP Guidelines 2010: 15 at Agent